

Since July 2002 German Pfandbrief issuers have been allowed to include certain derivatives transactions (hereinafter called “swaps”) in the cover pool of Pfandbriefe (hereinafter called “cover pool”).

On December 3, 2003 Standard & Poor’s, Frankfurt published “Criteria for Swaps Included in a Cover Register of German Pfandbriefe” (hereinafter called the “Cover Register Criteria”) and on December 17, 2003 S&P, New York published the “Standard & Poor’s Global Interest and Swap Counterparty Rating Criteria Expanded” (hereinafter called the “Expanded Criteria”) and on February 26, 2004 the criteria named “Global Interest and Currency Swaps: Calculating the Collateral Required Amount” (hereinafter called the “Collateral Criteria”). These documents were designed to set up certain rating criteria including the relevant criteria for ratings of Pfandbriefe taking into consideration swaps included in a cover pool. S&P considered the situation of a cover pool as being similar to an asset pool being part of a structured finance transaction. Therefore, S&P required that swaps registered with a cover pool register must meet the eligibility criteria developed for structured finance transactions (see page 1 of the Cover Register Criteria). The applicability of the Expanded Criteria and the Collateral Criteria to swaps included in a cover pool of a German Pfandbrief issuer has been confirmed orally by responsible employees of S & P. However, the Expanded Criteria and the Collateral Criteria shall, according to its terms, apply only to swaps used in a structured finance transaction (see Page 1 of the Expanded Criteria and the Collateral Criteria).

In July 2004 market participants started discussions with S & P, Frankfurt. It had been criticized , that the S & P Criteria may be tailored perfectly for swaps concluded by a SPV within the framework of a structured finance transaction, but the criteria appear to be inappropriate for swaps included in the cover pools of German Pfandbrief issuers. As apposed to a SPV a German Pfandbrief issuer is (a) governed by specific laws protecting the economic interest of holders of Pfandbriefe, (b) supervised by banking regulators, (c) provided with highly sophisticated risk management systems, etc. To give an example for inappropriateness (this example is mentioned here because it is self explaining ; however, it is not one of the criteria which raise serious material concerns): It is required to have (1) on a weekly basis an internal mark-to-market valuation of the swaps (2) which is to be verified by an external valuation monthly. Whereas this may be a necessary requirement for a SPV, having no risk management systems and therefore being dependant from third parties which can provide these systems, a German Pfandbrief issuer is a bank with all the appropriate risk management and control systems. So on the one hand the S & P requirement of weekly internal mark-to-markets is far under the banking standard (i.e. monitoring the swap risk on a daily basis) and on the other hand an external mark-to-market would be impracticable and unacceptable for the Pfandbrief issuer not only under the cost aspect.

On January 5, 2005 additional criteria have been published (“Extended Criteria on Collateral Agreements for Swaps in the Cover Register of Covered Bonds”) by S & P, Frankfurt without prior announcement to market participants. The discussions with market participants in summer 2004 where not reflected therein. Following publication of these criteria a German banking association was asking for further discussions with S & P with the aim to adapt the criteria to market practice. In September 2005 the arguments of market participants and S+P were discussed orally.

On March 2, 2006, S & P Frankfurt requested for comments on a draft of new “Rating Criteria for Swaps in European Covered Bonds”. This invitation for comments has been appreciated very much by market participants. The draft addressed many but not all of the concerns of the market. Certain market participants were asked to respond to S & P’s request with a 4 week deadline. Until end of July 2006 S & P did not answer to the comments.

Summary of points of concern:

1. The S+P criteria published in 2003 were not sufficiently tailored for the relevant market and the relevant market participants.
2. It took more than 2 years from the start of discussions with S+P to have at least a draft of a widely adapted set of criteria for swaps included in a cover register of a German Pfandbrief issuer. Until today there is no reliable basis for German Pfandbrief issuers as regards rating criteria for swaps included in a cover pool. It appears to us that the integration of local issues (e. g. legal framework for German Pfandbrief issuers and the relevant market practice) into S+P' s global perspective is not perfect. It is obviously difficult for S+P to find quickly an approach which fits to both the local market and S+P' s global rating strategy and rating techniques.
3. The language of the S+P criteria mentioned in this paper is unclear, partly contradictory and little structured.